financial *focus*

Kelly L. Adams, CFP®, EA

42705 Grand River Avenue
Suite 201
Novi, MI 48375
248.442.0877

kelly@harborlightplanning.com • www.harborlightplanning.com

Spring 2008

THE RECENT MARKET TURMOIL

by Bert Whitehead, MBA, JD, Franklin, MI

Financial advisors have been carefully following the market reaction to the collapse of the subprime lending market. How does the market turmoil that began last year relate to the investments selected using the Cambridge Advisors' Functional Asset Allocation?

The Worst

Some client portfolios have used mutual funds holding ultra-short bonds instead of money market funds. Many advisors have recommended these funds for several years. Although the net asset value does fluctuate—unlike what you would expect with a money market fund—the higher yield can provide a greater total return than money markets can.

In the market turmoil last summer, one such fund dropped from $9.69 to $9.55 per share. Although 14 cents, or 1.5%, may not seem significant, it is a considerable drop compared with the money market asset class. Even so, the ultra-short bond fund used in our office lost relatively little off its high for the year. Clients holding this fund for some time likely took only modest losses, if any, on such holdings.

Some advisors recommended their clients move their ultra-short bond investments into money market accounts, to avoid future fallout of the bond market. Money market funds weren't providing yields as high as we had come to expect from ultra-short bonds, but even smaller money market balances could find yields of about 4.5%, sometimes better.

INSIDE THIS ISSUE

2 Your Most Valuable Investment
The Recent Market Turmoil (cont.)

3 A Fiscal Fitness Annual Checkup

4 Are My Bonds Really Safe Investments?

The Best

Clients with long-term bond ladders funded with stripped U.S. treasuries have been well served, as have many with mutual funds holding U.S. treasury securities. During this collapse of the mortgage bond market, we have seen a so-called flight to safety, significantly increasing demand (and price) for Treasuries. As the uncertainty about mortgage bonds spread worldwide, there has been a global rush to buy U.S. Treasury bonds, so these yields have been dropping (and prices rising) while the yields of corporate, municipal, and junk bonds have been doing the opposite.

These circumstances demonstrate one of the strengths of Cambridge's strategy of Functional Asset Allocation. Clients with Treasury ladders in place have the peace of mind that these uncertain times will not affect their lifestyle for the next 15 years. I don't think we have seen the end of the fallout from this credit problem, even though governments worldwide have taken action to calm the markets. Although a similar scenario set off the Great Depression of the 1930s, today's situation is not analogous. And even though the doomsayers are carping about the collapse of our economy, such a disaster would require other catastrophic events to occur simultaneously (such as a cutoff of Mideast oil or a 9.0 magnitude earthquake in California).

The Rest

Although this situation has impacted the volatility of the stock market, stocks as a whole (excluding companies in the financial sector) will not be affected in the longer term. If the situation drags the economy down into a recession, however, we can expect the stock market to drop accordingly. Nonetheless, if client portfolios are well balanced, no immediate action is needed. Our office did not recommend changes to clients' stock (equity) portfolios based on the immediate fallout from the subprime mortgage crisis.

Continued on page 2, The Recent Market Turmoil

WORK STRATEGIES FOR EVERYDAY LIVING

YOUR MOST VALUABLE INVESTMENT

by Stewart Farnell, Ph.D., CFP®, Boulder, CO

What's your most valuable investment? The answer may surprise you. Your human capital, your earning power over the rest of your working life, may be your most significant asset.

That's why disability insurance is indispensable during your working life because it protects your family against the possible loss of your income. It also explains why spending money on furthering your education is a smart idea, even from a narrow financial perspective. The education increases your future earning potential.

So what's the best way to manage our human capital? What do we need to do, and how should we go about it?

Longer, more interesting careers.

Begin by recognizing that our working lives don't end at age 55 anymore. As we live longer, we must work longer to provide for the additional years after we retire when we won't be earning an income. The old way was to endure even an unrewarding job and take early retirement. But this approach is no longer viable. Instead, we all need to find fulfilling work that we can do with pleasure to age 55 and beyond.

One useful resource is Cali Williams Yost's book *Work + Life Fit: Finding the Fit That's Right For You*. Yost addresses finding the right kind of work by tailoring our life to our work and our work to our life. She explores how to have both a productive work experience and a rewarding life outside of work.

Keeping current with skills—and social groups.

One valuable strategy is to keep upgrading our skills, so we continue to enjoy a rewarding place in the changing work environment. Another important step is to recognize that we can't count on staying with the same employer the way an earlier generation did. A particular company or employer may be ideal for now, but it would be unwise to get too comfortable. We should be prepared to find a new job at any time.

The best way to explore new opportunities is through networking. But it's not feasible to build new relationships at a moment's notice, so keeping up with networking has become an essential ongoing aspect of managing a career. Some of us have well-honed networking skills. But if you don't, perhaps it's time to increase your networking opportunities: take a course, find a supportive professional or civic organization, and work actively on building new relationships.

Changing employment relationships.

The traditional employer/employee relationship can no longer be taken for granted. Either now or in the future, your work may take the form of consulting, where you work as an independent contractor rather than as an employee. Consulting work usually brings no employer-provided benefits. Also, consultants often are self-employed for tax purposes, so they pay both the employee's and the employer's share of Social Security and Medicare taxes. If you are negotiating a consulting contract, charge a higher rate than you would expect to receive as an employee to cover the absence of medical coverage, life and disability insurance, and retirement benefits, as well as the increased Social Security taxes. For self-employed consulting, it is not unreasonable to demand 50% more than you would receive as an employee.

These are some of the most important changes in our working lives. The better prepared you are to meet them, the more you will be able to leverage and benefit from your human capital. ■ ■ ■

Continued from page 1, The Recent Market Turmoil

■ REAL ESTATE INVESTMENT TRUSTS (REITs)

In the first few months of the crisis, the Vanguard REIT index dropped 5% to 10%; other REITs shed less of their value. This generally is due to the echo effect, where companies related to a problem industry can suffer a short-term downside swing, even though their profitability is not impacted. CGM Realty, a REIT fund that our office uses widely in client portfolios, has been virtually unaffected because it is primarily in commercial realty with little or no mortgage exposure.

■ The Long Run

Although it is sometimes useful to take action in response to specific market conditions, we do not try to time the market and we don't react blindly to market changes. They generally even out over the long run. If you have questions about the subprime mortgage crisis or what you should be doing now, contact your Cambridge Advisor. ■ ■ ■

A FISCAL FITNESS ANNUAL CHECKUP

by Robert Reed, CFP®; Columbus, OH

You're jogging, meditating, and eating more salads to stay in shape. You've learned how to measure your heart rate, cholesterol count, and blood pressure. That's great, but don't forget to look at your *fiscal fitness*, the ease that long-term financial security brings to life. So pull out your calculator and look at five indicators of your financial health.

1. **Consumer debt:** Add up the total interest you paid this year on your revolving charges, personal car loans, and other personal liabilities (not including your mortgage and business or investment indebtedness). Divide by your annual income. The quotient's the percentage you're being penalized for living beyond your means.
   EXAMPLE:
   Interest ($5,000) ÷ Income ($75,000) = 0.067, or 6.7%.

   0–1% **Congratulations!** You get a gold star.

   1–3% Typical range for middle-income families with new cars.

   3–5% You are living beyond your means. It's time to cut up the credit cards.

   5–10% You're in the danger zone. Talk with your advisor about making major changes.

   10% + The damage is probably irreparable. You may need to discuss bankruptcy planning with your advisor.

2. **Personal savings:** Take the total amount of cash stashed this year in permanent savings such as IRAs, SEPs, 401k plans, and insurance premiums paid on any whole-life policies, and divide by your annual income.
   EXAMPLE:
   Savings ($3,500) ÷ Income ($75,000) = 0.047, or 4.7%.

   0–1% You're in trouble and probably living beyond your means.

   2–4% You're headed in the right direction.

   5–9% Celebrate delayed gratification.

   10% Optimum level for long-term goals.

   11–19% You're playing catch-up or hoarding.

   20%+ Are you related to Ebenezer Scrooge?

3. **Fully funding your pensions:** Add up all the contributions to retirement plans *you* made last year (401k, 403b, 457, Federal TSP, IRA, Roth IRA, SEP, SIMPLE). Divide by your annual income.
   EXAMPLE:
   Total pension contributions ($2,000) ÷ Annual Income ($75,000) = 0.03, or 3%.

   0–1% Um, Virginia, there really *isn't* a Santa Claus.

   2–5% You can expect to make major lifestyle adjustments at retirement—*downward* adjustments.

   6–10% You're right on track.

   10%+ You're either self-employed, playing catch-up, or deferring too much life to retirement.

4. **Value of personal residence:** Measure the fair market value of your house as a percentage of your annual income. *EXAMPLE:*
   House ($100,000) ÷ Income ($75,000) = 1.33, or 133%.

   0–90% Feeling kind of cramped, eh?

   90–125% Time to trade up.

   125–150% Start looking for a new home.

   150–250% Just right.

   250%+ Consider renting out rooms.

5. **Liquidity:** Measure your liquidity as a percentage of total income. Liquidity is savings earning interest while stored in short-term investments such as CDs, U.S. Savings Bonds, guaranteed insurance contracts (GICs), and bank accounts.
   EXAMPLE:
   Short-term savings ($3,000) ÷ Income ($75,000) = 0.04, or 4%.

   0–10% You're plagued by a series of short-term cash flow crises.

   10–30% You're starved for liquidity.

   30–45% Optimum range for employed people.

   45–60% Target range for self-employed.

   60–90% Comfort zone for retired folks.

   90%+ You are either very well off or lacking diversity. ■ ■ ■

Financial Focus is a publication of the Alliance of Cambridge Advisors, Inc. ©2008. All rights reserved.

ARE MY BONDS REALLY SAFE INVESTMENTS?

by J. Mark Vorchheimer, CFP®, Spring Valley, NY

Most of us have heard about the importance of diversifying our investments. Simply put, diversification refers to a strategy of putting our money into a variety of investment types. For instance, if you invest in the stock market, you would not want your entire stock portfolio to be in one company. You would be better off investing smaller amounts in a variety of stocks.

Taking this idea further, you can diversify among various types of investments like stocks and bonds. Although investment diversification strategies are beyond the scope of this article, suffice it to say that diversification lowers the risk of losing your investment.

How do bonds help you diversify your portfolio? In a number of ways actually, but here are a few of the most essential benefits. First, stocks and bonds are *imperfectly correlated*—that is, they do not necessarily move in the same direction. When stocks are up, bonds may be down, and vice versa. Second, generally speaking, bonds are far more conservative investments than stocks, which are more risky and volatile. So if stocks were to take a plunge (as they have recently), bonds can cushion the blow to your investment portfolio because they are generally more stable. This is true both with bonds that are backed by large and stable companies and those backed by large and stable municipalities or countries.

The financial world generally perceives the U.S. government to be the most stable and reliable issuer of bonds. Consequently, U.S. treasury securities (which are fully backed by the federal government) are likely to be the safest investments you can buy—the least likely to lose their value. With that said, even U.S. government bonds fluctuate in value. They do so because all bonds inherently have some risk factors associated with them. Here are some of them:

- **Credit or default risk:** The possibility that the bond issuer will not be able to repay the loan.
- **Interest-rate risk:** The chance that a fixed-rate investment will decrease in value due to an increase in interest rates.
- **Exchange-rate risk:** The chance of loss because of changes in foreign currency exchange rates.
- **Liquidity risk:** The possibility that you will not be able to buy or sell an investment quickly enough or in large enough quantities due to limited supply and demand.
- **Inflation risk:** The chance that inflation will erode the buying power of the investment.

Among all of these risks, credit risk is by far the one that can have the most significant effect on the bond investment. After all, a bond is, in essence, an IOU from an organization or government. If the borrowing entity (bond issuer) cannot or will not pay back the loan to the lender (the bond holder), the bond may become worthless.

In recent months, as the mortgage crisis has unfolded, it has become clear that not all bonds are created equal. In the mortgage industry there are various levels of loan quality depending on the perceived ability of the borrower to repay the loan in a timely fashion. Many lower-quality mortgage bonds were backed by subprime mortgages, where the borrower could never afford to pay back the lender in the first place. In these instances the approval process for the loan may have been no more than a formality, with little or no due diligence as to whether the borrower would be able to make the loan's monthly payments. Because a bond is only as valuable as the financial stability of the borrower to make timely payments, we can understand why more than $100 billion of these loans are already considered worthless—and the number is growing.

Why, you might ask, would large banks and brokerage houses invest so much money in these mortgages if they were of such poor quality? There are probably many parts to a complete answer to this question, but one factor almost certainly was the significantly higher interest rates these loans were offering the lenders (and subsequently those who bought or invested in these loans). After all, all things being equal, if you are investing in bonds (essentially IOUs), why not get the highest interest rate possible for your investment? Why settle for 3% or 4% when you can get 10% or 15%? The answer is that all loans are *not* created equal, and if you are being offered 15% on your money, perhaps you won't see all the monthly payments you are expecting.

If you haven't reviewed your investments in a while, sit down with your financial advisor. Take a good look at the fixed-income portion of your portfolio, which should be acting as the cushion to your more volatile investments in the stock market. Analyze not only the *quantity* you have invested in bonds, but just as importantly the *quality* of those bonds. Ask yourself if you would rather agree to a lower interest rate and be relatively certain you will receive all your monthly payments or a higher interest rate but with a greater likelihood that you may not receive all your payments. In most cases, Cambridge Advisors recommend bonds of high quality. Because ultimately, you can't rely on your cushion to ease the often bumpy ride in the stock market if the cushion is pulled out from under you. ■ ■ ■